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No. 89-715

In the Supreme Court of the United States

OCTOBER TERM, 1989

WILLIAM F. OWEN AND GRETCHEN K. OWEN,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a taxpayer who transfers property to a controlled corporation realizes taxable gain on the transfer under Section 357(c) of the Internal Revenue Code to the extent the transferred property is subject to liabilities that exceed his adjusted basis in the property, even though the taxpayer remains personally liable for those liabilities following the transfer.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A8) is reported at 881 F.2d 832. The memorandum opinion of the Tax Court (Pet. App. A9-A25) is reported at 53 T.C.M. (CCH) 1480.

JURISDICTION

The judgment of the court of appeals was entered on August 9, 1989. The petition for a writ of certiorari was filed on November 2, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

STATEMENT

1. In 1977, petitioner William F. Owen and Stephen McEachron formed a general partnership called McO Investment (McO), in which they were equal partners.[1] In 1980, petitioner and McEachron entered the seismic drilling business. They borrowed money to buy drilling equipment, personally guaranteeing the loan and giving the lender a security interest in the equipment, and they placed title to the equipment in the partnership. The partners then leased most of the equipment to Western Exploration, Inc., a corporation in which petitioner and McEachron each owned 50% of the shares, and Western proceeded to conduct the seismic drilling operations. Pet. App. A2, A10-A12.[2]

The seismic drilling venture was unsuccessful. Petitioner and McEachron decided in 1981 to abandon their efforts and to sell the entire venture. They believed that the sale of their business could be more readily accomplished if it were first combined into a single entity. Accordingly, petitioner and McEachron decided to transfer ownership of the drilling equip-

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[1] Petitioner Gretchen K. Owen is a party to this suit solely by virtue of having filed a joint return with her husband William; accordingly, references to "petitioner" are to William F. Owen.

[2] Petitioner and McEachron chose to have McO own the equipment and Western conduct the drilling operations because the partnership's ownership of the equipment would allow them to claim the investment tax credit and depreciation deductions associated with the equipment on their individual tax returns, while the use of a corporation to conduct the drilling operations would provide them with protection against personal liability in case of a catastrophe. Pet. App. A11.

ment from McO to Western and then sell their stock in Western. The equipment transfer was effected on December 31, 1981. As of that date, the transferred equipment was subject to liabilities of $988,008, which exceeded McO's adjusted basis in the equipment by approximately $200,000. Pet. App. A3, A12-A13.

2. On audit, the Commissioner determined that, pursuant to Section 357(c) of the Internal Revenue Code,[3] McO realized taxable gain on the transfer of its drilling equipment to Western to the extent the liabilities to which the equipment was subject exceeded McO's adjusted basis in the equipment.[4] The Commissioner's resulting adjustments to McO's income produced corresponding deficiencies in the income tax of its two partners, petitioner and McEachron. Each partner petitioned the Tax Court for redetermination of the asserted deficiencies, and their cases were consolidated for trial and opinion. Pet. App. A10.

The Tax Court ruled in favor of the Commissioner (Pet. App. A9-A24). Petitioners' principal contention in the Tax Court with respect to the Section 357(c) issue was that, pursuant to an oral agree-

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

[4] Section 357(c)(1) of the Code provides that, in the case of a transfer of property by a taxpayer to a controlled corporation, "if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred * * *, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

ment with the Wayzata Bank that was in effect by December 31, 1981, the bank had released its security interest in the transferred equipment to the extent that interest exceeded McO's adjusted basis in the equipment. Therefore, petitioners argued, the liabilities to which the transferred property was subject did not exceed the adjusted basis of the property, and Section 357(c) did not require the recognition of any gain on the transfer. See Pet. App. A19. The Tax Court found as a factual matter, however, that the bank did not agree to the reduction of its security interest until September 1982. It also concluded that this agreement should not be treated as retroactive to December 1981. The court thus concluded that at the time of the equipment transfer the liabilities to which the property was subject did exceed McO's adjusted basis, resulting in taxable gain under Section 357(c). Pet. App. A21-A23.[5]

3. On petitioners' appeal, the Ninth Circuit affirmed (Pet. App. A1-A8).[6] The court declined to

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[5] The Tax Court did agree with petitioners' contention that a $100,000 certificate of deposit pledged by the partners as additional security for the debt owed to the Wayzata Bank should be treated as a reduction in the amount of indebtedness to which the equipment was subject on the date it was transferred to Western. Pet. App. A23-A24. This treatment produced a corresponding $100,000 reduction in the amount of gain that McO was deemed to have realized on the transfer under Section 357(c)(1). The Commissioner did not appeal the Tax Court's ruling on this issue.

[6] McEachron, a resident of Minnesota at the time he filed his Tax Court petition, appealed to the Eighth Circuit advancing the same arguments as petitioners. The Eighth Circuit also affirmed the decision of the Tax Court, *McEachron* v. *Commissioner*, 873 F.2d 176 (1988), and McEachron did not seek certiorari.

disturb the Tax Court's conclusion that, despite the 1982 agreement of the bank to reduce the liabilities encumbering the property, the liabilities did exceed the partnership's adjusted basis in the property at the time of the transfer (*id.* at A8).[7] The court also rejected petitioners' alternative argument that, even if the liabilities did exceed the adjusted basis in the equipment at the time of the transfer, Section 357 should not require the recognition of taxable gain because petitioner remained personally liable for the indebtedness to which the property was subject and therefore he received no economic benefit as a result of the transfer. The court held that, under the statutory scheme enacted by Congress, petitioner's continuing personal liability for the loans secured by the transferred equipment is irrelevant. Pet. App. A5-A8.

ARGUMENT

The court of appeals correctly rejected petitioners' contention that the plain terms of Section 357(c)(1) should be disregarded and instead a limitation read into the statute to the effect that liabilities to which transferred property is subject may be ignored in computing the transferor's gain under Section 357, to the extent the transferor remains personally liable for the indebtedness secured by the transferred property. The court of appeals' decision accords with the decisions of the other courts of appeals that have considered this issue, and it does not confiict with any decision of this Court. Accordingly, there is no reason for review by this Court.

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[7] Petitioners do not seek review of this aspect of the Ninth Circuit's decision.

1. The general rule of Section 351(a) of the Code is that no gain or loss is recognized by a taxpayer on the transfer of property to a corporation controlled by him. Section 357(c)(1) expressly establishes an exception to that rule. If, in the case of a Section 351 transfer, the sum of the liabilities assumed by the transferee plus the amount of the liabilities to which the property is subject exceeds the adjusted basis of the transferred property, then that excess "shall" be considered as taxable gain to the transferor. Petitioners do not challenge in this Court the factual determinations that the partnership transferred property to a controlled corporation and that the liabilities to which the property was subject exceeded the partnership's adjusted basis in that property. Thus, the plain terms of Section 357(c)(1) dictate the result reached by the courts below.

Petitioners contend, however, that the partnership should not be treated as having realized any taxable gain on the transfer because the partners remained personally liable for the loans secured by the transferred property. But petitioners do not suggest how the text of Section 357(c)(1) can be read to support this rule. Nor do they provide any arguable basis for disregarding the apparent meaning of the statutory language since they suggest no reason for believing that the result reached below is at odds with the intent of Congress. See, *e.g.*, *United States* v. *Ron Pair Enterprises, Inc.*, 109 S. Ct. 1026, 1031 (1989); *Griffin* v. *Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982). Thus, the partners' personal liability for the indebtedness provides no basis for departing from the taxable gain consequences required by the plain statutory text, and the courts consistently have so held. See *Smith* v. *Commissioner*, 84 T.C. 889, 909

(1985), aff'd, 805 F.2d 1073 (D.C. Cir. 1986) (Table); *Rosen* v. *Commissioner*, 62 T.C. 11, 19 (1974), aff'd, 515 F.2d 507 (3d Cir. 1975) (Table); *McEachron* v. *Commissioner*, 873 F.2d 176 (8th Cir. 1988).

Moreover, contrary to the main thrust of the petition, there is nothing unreasonable or unfair about the application of Section 357(c)(1) in the circumstances of this case. Petitioners' assertion (Pet. 19-24) that the partners realized no economic benefit as a result of the transfer of the equipment from McO to Western ignores the fact that they obtained substantial tax benefits through the accelerated depreciation deductions claimed by McO with respect to that equipment. As the Tax Court has explained, Section 357(c)(1) "is analogous to other recapture provisions in the Code"; its purpose is to recapture tax deductions attributable to property acquired with borrowed funds, where the property is transferred to a controlled corporation and the liabilities to which the property is subject (or that are assumed by the transferee) exceed the transferor's adjusted basis in the property. See *Rosen* v. *Commissioner*, 62 T.C. at 19 n.3.

Upon its purchase of the drilling equipment in question, McO acquired a depreciable basis in the equipment equal to its cost. I.R.C. § 1012. This cost basis included the amount of the liabilities to which the equipment was subject by virtue of the financing arrangement between McO and the Wayzata Bank. See *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). McO's basis in the equipment was adjusted downward as it claimed depreciation deductions with respect to the equipment. I.R.C. §§ 167, 1016. It is because of this downward adjustment in McO's basis in the equipment (reflecting its recovery of its in-

vestment through depreciation), without a corresponding reduction in the indebtedness encumbering the property, that the liabilities to which the equipment was subject exceeded McO's adjusted basis on the date of the equipment transfer. In enacting Section 357(c)(1), Congress considered it likely that, in order to avoid foreclosure, the new owner of transferred property that is subject to liabilities will satisfy those liabilities regardless of whether it has any personal obligation to do so. Absent the recapture provisions of Section 357(c)(1), the satisfaction of those liabilities by the transferee would result in unwarranted tax benefits for the transferor because the transferor has already received the benefit of depreciation deductions computed on the assumption that he would satisfy the liabilities to which the property is subject. See *Rosen* v. *Commissioner*, 62 T.C. at 19 n.3.

Thus, petitioner's continuing liability for the indebtedness secured by the equipment transferred to Western is irrelevant; the statutory scheme is based on the expectation that the new owner of the property (*i.e.*, Western) will satisfy that indebtedness. If this assumption proves unfounded, it will result in no unfairness to the partners, as petitioners candidly recognize (see Pet. 16). In that event, the partners' basis in their Western stock would be increased to reflect the reduction of indebtedness, which would serve to increase their loss or reduce their gain on their disposition of that stock.

In essence, petitioners' complaint is that the statutory scheme is founded on the wrong assumption, which, they assert, can affect the "timing and character" of the tax (Pet. 16). In petitioners' view, where the transferor of property remains personally

liable for indebtedness to which the transferred property is subject, it should be presumed that the transferor, not the transferee, will satisfy those liabilities. If so, the transferor should not be treated as realizing gain at the time of the transfer, but rather should realize gain only in the event that it is the transferee who satisfies the indebtedness. The simple answer to petitioners' argument is that, while Congress could have chosen to adopt such a statutory scheme based on the assumption that the transferor will satisfy the liability, it clearly did not do so. The courts below correctly applied the statute that Congress chose to enact. See *Commissioner* v. *Asphalt Products Co.*, 482 U.S. 117, 121 (1987).

2. Contrary to petitioners' contention (Pet. 12-14, 17-19), the decision below does not conflict with that of the Second Circuit in *Lessinger* v. *Commissioner*, 872 F.2d 519 (1989). In that case, the transferor, at the time of a transfer that on its face appeared to come within Section 357(c)(1), obligated himself to pay the transferee an amount equal to the excess of the liabilities assumed by the transferee over the adjusted basis of the property subject to those liabilities. This obligation was entered on the transferee's books as a receivable due from the transferor, and the transferor subsequently gave the transferee a note evidencing his obligation to pay the amount of the receivable. Although the Tax Court was of the view that the receivable had no effect on the applicability of Section 357(c)(1), the Second Circuit reversed. It held that the receivable constituted additional property transferred to the transferee and that the property had a basis in the transferee's hands equal to the face value of the transferor's obligation. 872 F.2d at 525-526. Under this analysis, the liabilities to which the transferred property was subject

did not exceed the adjusted basis of the transferred property, and, consequently, the court of appeals held that the transferor recognized no gain on the transfer under Section 357(c)(1).

While the correctness of the Second Circuit's decision is, in our view, open to question, its holding does not conflict with the decision below. The court in *Lessinger* held that no gain was realized on the transfer because, after taking into account the receivable due from the transferor, the liabilities to which the transferred property was subject did not exceed the adjusted basis of that property. In other words, the Second Circuit held that no gain was realized because, in its view, there had not been a transfer that came within the terms of Section 357(c)(1). That holding is fully consistent with the decision below that when a transfer does come within the statute, gain must be recognized in accordance with its terms, notwithstanding the fact that the transferor remains personally liable to a bank for the indebtedness to which the transferred property is subject.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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